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LETTER 882

THE MARKET: Everyone and his brother has advanced a logical and obvious explanation for why the market has fallen in 1984. And that bothers me. History indicates that the real reason for most market declines (and advances) is only known months after the actual event. I would say that the market slide here in 1984 will be no different.

All eyes do seem to be glued on one area, and that area is interest rates. The yield on the blue-chip Dow Industrial Average is now 4.73%, the yield on the broad Standard & Poor's 500 Stock Index is 4.64%. Against this, S & P AA bonds now yield 12.24% and the long-term Treasury bonds yield just over 12%. Thus, the yield spread is roughly 7.5% in favor of high quality bonds over stock yields. This means that stock yields would have to rise about 160% to equal bond yields. And that would take some doing.

There is nothing more difficult than predicting the direction of interest rates. Right now many of the leading economic pundits are forecasting long-term rates of 13-15%, and the prediction of "higher rates" is almost a consensus, which might make one a bit skeptical. The single most bullish thing that could happen to the markets (and the nation) would be a dramatic paring down of the Federal deficit, but that would require decisive leadership from President Reagan and cooperation from Congress, events that may be reserved for 1985 and beyond.

I've said before that I feel that the markets have now taken over from the politicians. What the politicians won't do, the markets will force them to do. It is simply a matter of *timing*. Thus, a steadfast refusal to cut the deficits will ultimately bring the market and the nation to its knees. At which point, the politicians will have to do what they should have been doing all along.

The hardest thing to do in this business is to think and act *unemotionally*. Consider this: an investor takes a large position in stock X. The stock starts falling. Having boasted to his wife, his accountant and his neighbor about the wonders of stock X, the investor now has to face the fact that the market doesn't agree with him on his appraisal of X. The investor (through pride of opinion) sits with stock X and watches it fade into the sunset. After a horrendous loss, the investor swears never to go near the stock market again—until the next time.

Next case: an investment advisor maps out a tremendous bullish case for the market. He insists that all his clients get in. The market proves unobliging, and the base that the advisor saw turns out to be an immense top. But the advisor has "taken his stand," so to speak, and he stubbornly insists it's a bull market even as Wall Street unravels. A year later the market hits bottom, the advisor has lost 365 nights of sleep, and his followers have suffered the experience of riding through a major bear market. What has really occurred? The advisor has received a never-to-be-forgotten lesson in pride of opinion, and many of his subscribers have learned that the market can do anything (including

destroy their bank-roll). Most letter writers have gone through this one at one time or another (hopefully, it's a lesson we learn early in the game).

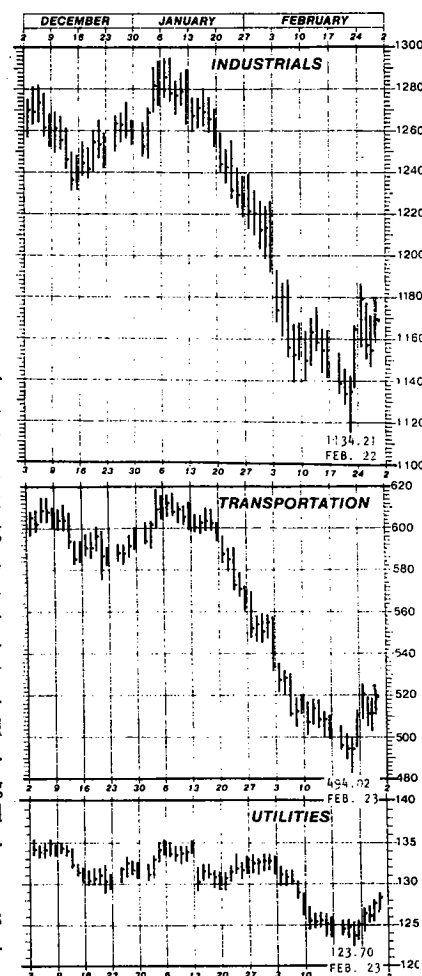
All right, let's move to the present. We've had a big spill in the stock market. During January and February alone the D-J Industrial Average lost 8.3%, the D-J Transports lost 14.6%, the D-J Utilities lost 3.1%, the S & P 500 lost 4.8%. And my PTI lost 77 points.

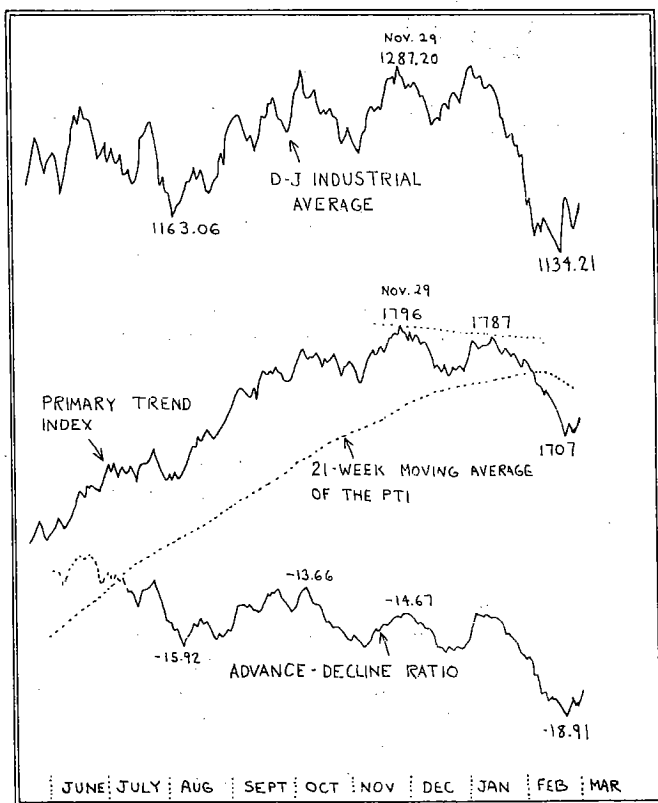
During the week ending February 24 the stock market registered heavily over-sold, following a string of downside days in which the advance-decline line dropped lower on an incredible 27 out of 33 days! During the January-February decline all the major averages broke below their late-1983 lows, the long-term moving averages turned down, and my PTI plunged below its 21-week moving average. The decline continued to February 23.

Then came February 24 and 27, two days which saw the Dow up a combined 35 points (see chart 1). February 28 saw a 22 point drop, and then came minor fluctuations and a feeling of equilibrium. March 2 saw the market strongly higher again.

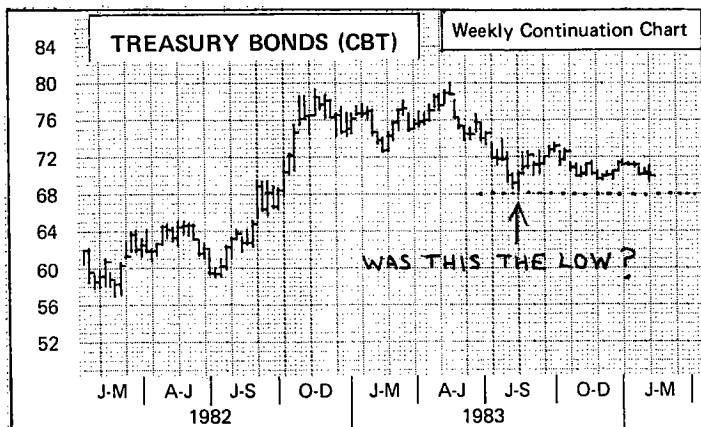
After an almost straight-line drop of 153 points in the Dow (from the January 17 to the February 22 low) I would expect more rally. And looking at the page 1 chart, it looks as if small head-and-shoulders bottoms have formed. Perhaps one more scary "downer" could materialize, but I would expect increased upside action following the current over-sold condition of this market.

There are a few items here that I want subscribers to think about.





(1) The bond market has not yet really broken, and this is a plus for the stock market. Watch the near-month CBT (commodity) bond contract. To crack, this contract would have to fall below 68. It has not done so yet. (Bond chart courtesy Dunn & Hargitt).



(2) We have not seen an authentic Dow Theory bear signal yet. To get a bear signal, the D-J Industrials and Transportation Averages would have to rally substantially for a few weeks or more, then turn down and break the late-February lows. That may happen yet, but let's not try to outguess the market.

(3) The PTI is now well below its moving average. The 21-week MA is now 1748 and the PTI is currently 25 points below 1748. As long as the PTI is BELOW the 21-week MA, we are in the "fail-safe" position, which is out of the market. If the PTI rises above its MA again, we will have to consider the possibility that we have been through a whip-saw, in which case I would suggest a move back into the no-load stock funds again. Over the years I have found it a healthy policy to stay on the right side of the PTI. The last confirmed trend of the PTI was bearish.

(4) Bear in mind that there are 42 million investors "out there" as well as probably 5 million computers—all trying to figure out what is going on. Therefore, we can expect this market to pull a lot of tricks. But we don't have to be in a rush to do anything.

INVESTMENT POSITION: Dow's Theory has not yet identified this as a primary bear market. But because the PTI is in a declining trend, I have kept the bull out of the box. The preferred position at this time is predominately cash (or money market funds or T-bills). I'm particularly fascinated with the longer term bond market here—particularly since it has universally proclaimed that "interest rates must move higher." Dr. Kaufman came out again this week stating that long rates would be 13% by year's end. If Kaufman is wrong, it will be a major plus for the stock and bond markets.

THE PICTURE: San Diego society is now embroiled in a giant financial mess. The local La Jolla company of J. David had hundreds of accounts and was reputedly doing bond trading, municipal bond trading and foreign currency trading, among other things. The minimum accounts were reputed to be \$50,000. The size of the foreign currency account was reputed to be \$100 to \$150 million. But recently the company was thrown into bankruptcy (Chapter 7). And the biggest question in San Diego is, "What happened to all the money?" So far, nobody knows where the money is or what happened to it. The grand jury, the FBI and the IRS are working on it.

Customers of J. David received statements with no transactions showing. All that showed was whether the account experienced a profit or a loss for the month. So scores of San Diegans are now biting their finger nails and waiting for information on what happened to their money. The case of J. David surpasses most good detective stories for sheer suspense and mystery.

And I ask myself, what prompted these scores of people to invest thousands (in some cases millions) of dollars in this company? And the only answer I can come up with is greed—the blind hope of making money the easy way.

Anyone with even a few years experience in the markets knows that there is no easy way to make money. At least there is no easy way to make money honestly—and if you make it dishonestly you have to deal with your own bad karma, your battered conscience and the possibility (even probability) that all the dirty water will come out in the end.

As far as investing in today's markets is concerned, the investor in the 1980s has to deal with a few unique situations. (1) Today's investor is dealing with an instant communications market. What Charlie the Trader in New York knows this morning is going to be flashed on the D-J or Reuters tape this noon. The hottest news in the nation today is financial news, and every newspaper, radio station and TV station is scurrying to flash the latest financial news on its wires. In other words, information now moves faster than ever. As a result, the market moves faster than before, and it tends to move in a straight line.

(2) Institutions now control market trading. They may not hold the bulk of assets, but they do execute the bulk of trading. And the institutions tend to form a consensus, they tend to follow each other.

(3) Technical analysis is now widely accepted. The spread of computers simply intensifies the search for statistics, methods and formulas for operating in the market.

(4) Today's stock market is operating in an era of the monster debt. Today's massive debts tend to keep interest rates very high. Thus, the stock market right now is competing with Treasury bonds yielding over 12%. These high rates present a constant danger to stocks, since the yield spread in favor of stocks over bonds is 6 to 8%. Furthermore, the climate for bonds is anything but healthy. Thus, the bond/stock relationship is tenuous and rather dangerous with the added problem of bonds themselves being on thin footing.

(5) Towering over the entire financial scene is the problem of \$200 billion in Federal deficits stretching out as far as the eye can see. At this point, neither the Administration nor the Democrats have presented any workable plan to handle the debts and deficits.

(6) Finally, the forces of inflation and deflation are now in delicate balance. The deficits and financing the deficits are basically a deflationary process. Paying over \$3 billion a week on interest on the Federal debt is a deflationary process (it acts as a sponge, sopping up all available money). But monetizing the debt or providing the money for paying the deficits and debt is basically an inflationary process. Thus, the forces of inflation and deflation have met head-on, and this financial tug-of-war is a major element of instability in today's market..

What is the investor to do? As I see it, there are three really intelligent and workable methods of operating in the markets of the 1980s.

(1) Diversification (and I have stressed this over and over again). One can put say 1/3 of his liquid assets in T-bills or a money market fund, he can put another 1/3 in stocks or a mutual fund, he can put perhaps 20% into top-grade bonds and the rest into gold coins. This kind of portfolio is obviously not fool-proof, but one segment will tend to off-set the other. The total result will be that the diversified investor will probably sleep fairly well. He will also not spend endless hours and days trying to figure out what each segment of the market will do. In effect, he is hedged in almost all directions. (I am not including one's home or business, although they also constitute diversification.)

(2) The value investor. This person will buy only great values and then only during market panics or near bear market bottoms. Great fortunes have been made by this method, but the method requires a knowledge of markets, a faith in the thesis that markets throughout history have been subject to periodic panics, and that at such times (i.e., during panics) many good stocks will slide below known value. The value investor must be able to say, "This market crash is providing me with some great opportunities. Macy's at 10 and General Cinema at 5 and Metromedia at 10 are great buys. And if I'm wrong, it looks like the nation won't survive, so I might as well buy 'em here." This is exactly what my subscribers and I did in late-1974. We may get another shot at it in 1984.

(3) There is a third kind of investor who says, "All is well and good, but my nerves require that I have some kind of technical system. I can't sit and wait for the panic of the decade. And I can't watch while the common stock portion of my portfolio collapses, even if the gold portion is exploding. I've got to have

a real guideline." So this person searches for a system or method for keeping him on the right side of the major moves in the market. The devices and methods of this investor are too numerous to mention, but there is nothing wrong with this approach—assuming the person has the mental strength to stick to his system.

What do I do? Personally, I use all three systems described above. I diversify. I also place great stress on buying values, and finally I do follow technical analysis closely—with special emphasis on staying on the "right side" of my Primary Trend Index (PTI).

At this time I want to discuss a subject that I have never discussed before. That is, buying items that can't (or are very unlikely) to go broke. This sounds like a sort of comic approach to investing, but I assure you that it is not. For instance, if you decide to cost-average or carry certain stocks in your portfolio, picture this (and it often occurs): you are holding a secondary stock called Infra-Genetics. The stock has dropped from 70 to 40, and you are in the throes of a bear market. The stock continues down to 25, then 20, then 15. Your broker calls you and tells you that there's a rumor that Infra-Genetics is about to file for bankruptcy. The rumor spreads like wildfire on Wall Street. You end up dumping the stocks at 3 for a frightful loss.

Take another situation: you are holding J.P. Morgan stock and the stock is down from 83 to 65. A bear market is in force, and the stock goes down to 50. At 50 the \$4 dividend provides a yield of 8%. You say to yourself, "JPM isn't going broke, and if it does, the nation will probably be broke too. I'll sit with the stock or maybe even buy more if the yield hits 10% or over." You can substitute any good mutual fund or any blue chip stock for Morgan, and the psychology is the same. You're not worried about bankruptcy, and you can say to yourself, "I'm sitting with the best there is."

"If the market ever comes back my stock is going to come back with it." And believe me, that's a huge source of comfort in a vicious bear market, particularly when you have a diversified portfolio and a plan for operating during any kind of market.

DEBT, MONEY, ELECTIONS: It was in 1980 that I said that the forces of inflation and deflation were finally meeting head-on in a death-struggle. I took that position because I felt that the US debt structure by 1980 had grown so huge (and it was still growing) that the actual cost of supporting the debt had become deflationary.

Only three things can happen to debt. (1) You can pay it off, and the US Government is not about to do that. (2) You can renege on it, and I don't think our Treasury is ready to declare bankruptcy yet. (3) You can inflate the debt away, and that's what this country has been doing for decades.

Because approach number 3 is the one the US has been following, I came up with two expressions: (1) In an economy that is loaded with debt, "not enough inflation is deflationary." In other words, if it takes 10% inflation to "handle" the deficits, an inflation rate of 5% becomes a deflationary rate. And that's what is occurring today.

The second adage that I coined was, (2) The US must "inflate or die." In other words, there is no choice in a debt-ridden economy

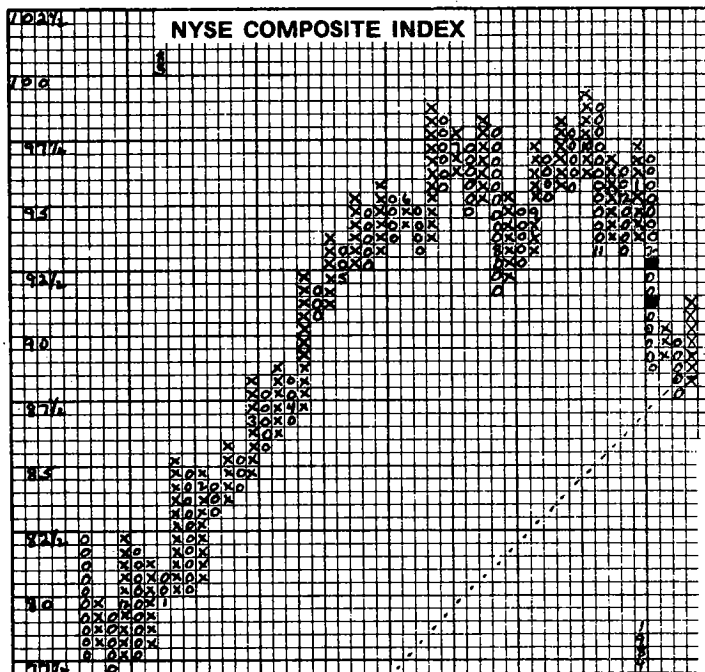
except to continue inflating the debt away or to take the consequences which are deflation, depression and perhaps bankruptcy.

Right now Mr. Volcker and the Administration face a dire situation. There's an election coming up, and there are massive deficits to finance. Mr. Volcker is not monetizing the debt fast enough, and the stock market knows it. The result could be a recession, and this is all occurring during an election year.

What happens next? My feeling is that Volcker (1) has been trying to force Washington to cut spending by putting the pressure on the money markets. (2) I also feel that Volcker wants to go down in the history books as the man who single-handedly beat inflation. "Nonsense," reply the cynics, "the Fed always opens the money valves before election and it will do the same thing in 1984. Gold knows that, and that's why it is rising. History will repeat."

And that's a pretty convincing argument. Look at this chart (courtesy of Jim Blanchard's Market Alert). It shows what happened to M-1 prior to previous elections. The only time in the last quarter century that M-1 did not explode prior to an election was 1976, at which time the incumbent (Ford) lost to Carter. So even though the Fed is an "independent agency," many claim (and with good reason) that the Fed is nevertheless an arm of the Administration.

Personally, I'm not at all convinced that Volcker is going to open the spigots here in 1984. I think Volcker is trying for that elusive situation—stability. But stability is very difficult to engineer in an economy where Federal deficits are piling up at the rate of \$200 billion a year. Maybe Volcker can do it, and the gold market seems to feel that he will try. But the stock market is still sceptical. The stock market appears to be girding itself for something approximating a recession. Time will tell.



From there the Composite plunged to 88. Since then a small reversal formation has formed, and at 91 last week the NYSE Composite turned near-term bullish. My guess is that the Composite will run into massive resistance in the 93.5 and above area. At that time, we will have a better chance to appraise the market action. (Chart courtesy of Chartcraft, Larchmont NY).

NOTES & QUOTES: Tacticians and armchair strategists are still mulling over the US "redeployment" of the Marines in Lebanon. In the WSJ of February 23, Josef Joffe presents his three rules for coming up on top. "Why did the mightiest power on earth fail so miserably in Lebanon?" Joffe answers the question by saying that we didn't stick to the rules. And here they are.

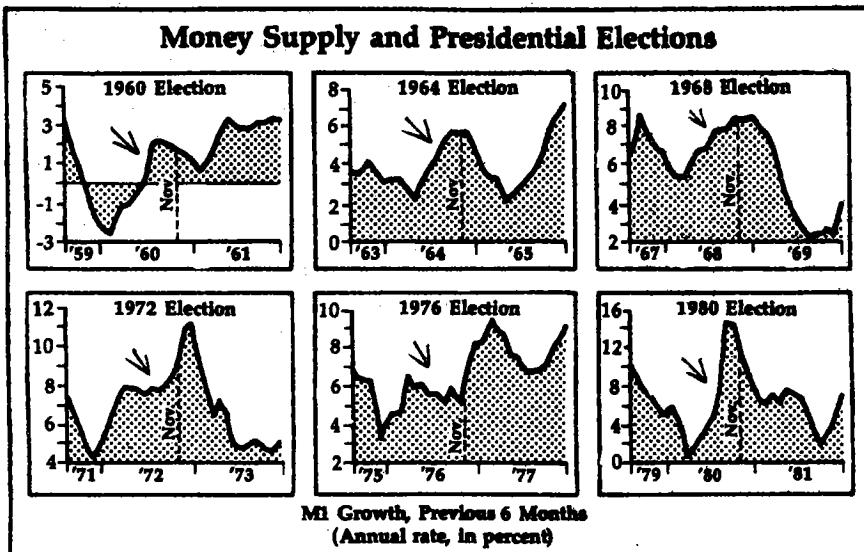
Three Sure-Fire Rules

The Grenada invasion worked because it heeded the three sure-fire rules of successful intervention. First, never pick on anybody your own size. (Corollary: Use three times as much force as necessary.) Second, do it close to home or where the balance of power and interests is vastly in your favor. Third, take care to invade only friendlies. Sadly, this triple-caveat leaves only the likes of Suriname and San Marino for future demonstrations of American resolve.

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Last year when I was down in New Orleans we ate at K-Paul's restaurant. Now frankly, I have always been disappointed by the so-called "fabulous" New Orleans food. But not this time. K-Paul's is a dining experience of the first order.

This month Bon Appetit magazine features K-Paul's and so does the new (March) Life magazine. The restaurant is run by 400 pound Paul Prudhomme and his wife Kaye. The food is hot, different and spectacular. And the restaurant is super-popular. Paul takes no reservations, accepts cash only (no credit cards) and you sit at tables with strangers (there are NO empty seats). Furthermore, if you want to get seated you stand in line at 5P.M. and if you're lucky you get in at 5:30. I'm a fellow who hates lines, but I will tell you—it's all worth it!



PERSPECTIVE: This is a point & figure chart of the broad NYSE Composite. Each box represents 1/2 of the Composite and only changes (rallies and declines) of 1.5 points or more are shown. What we see here is a formation that has the appearance of an immense top. The breakdown came in February when the Composite touched 93. This is the higher blackened box on the chart. The more definitive break came 91.5, shown on the lower blackened box.

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I'll be in NYC in late March and I'll be eating in what I think is the best (and most under-rated restaurant) in the City, Cote Basque. From there I'll go down to Washington to appear on Wall Street Week with big Louis. One reason I'm going is that I'm going to try to get across my feelings on the crisis situation that is building via the Federal debt.

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It has been said that on a surface level all life is a comedy, but on a deep level life is a tragedy. Much the same can be said about politics. Along these lines, I got a laugh out of this piece (from a book review) by C. Lehmann-Haupt of the New York Times (Feb. 28):

ONE caricature of the years from 1960 to 1980 might go as follows: President Kennedy sought to get America moving again after the doldrums of the Eisenhower era, but he was killed before he had a real chance to try. His successor, President Johnson, pushed what he had begun beyond reasonable limits, which led to upheaval, violence and President Nixon, who overdid things so much that the country turned to Jimmy Carter, who underdid things. In the process of it all, the nation grew fed up with Government and elected Ronald Reagan, who promised to do away with it. The rest is whatever the arms race and the Federal deficit may have in store for us.

* *

Alan Saxon of Bullion Reserve of North America committed suicide when he couldn't face his investors and their \$60 million losses. A tape made by Saxon provides an insight into big-time (amateur) commodity trading. Didn't they used to say that "The worst thing that can happen to you is to make a profit on your first trade." Here's part of the tape:

He explained briefly how the customer funds were lost. "For the record, this is what went wrong," Mr. Saxon said. He then proceeded to recount how he had invested \$100,000 in commodity futures in 1981, which brought \$1 million of profit in a little more than five weeks. After several more months of profitable trading, however, his luck changed. "After erasing all the gains that I had made, it started to go negative," he said. Without supplying specific details, he stated that "most of (Bullion Reserve's) losses can be traced to staggering losses in commodities trading." Reflecting on what had happened, he added, "I really think I lost my touch, or at least whatever touch I

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In his February 25 report, Joe Granville writes that "I admire Richard Russell for his candid admission that he had been wrong on this market, now recognizing the fact that this market is coming down from a huge top." I appreciate the sentiment, Joseph. In case you are wondering what Joe is saying now, in an interim report just received Joe notes that "even a dead

body falling from the Empire State Building will bounce. These developments (Ed., the rally) have no long-term implications." Granville thinks that what's coming up will very likely resemble 1929. To put it mildly, Joe is not bullish!

QUESTION: Russell, what do you suggest I put in a new IRA or pension plan?

Answer: Where any plan is tax deferred as these plans are I would unhesitatingly say, "Put your money in the highest yielding items with safety that you can find." The only problem here is one of maturity. If you are 20 years old, I would probably suggest a 30 year maturity Treasury bond. If you are 50 years old, I would probably buy a 10 year maturity.

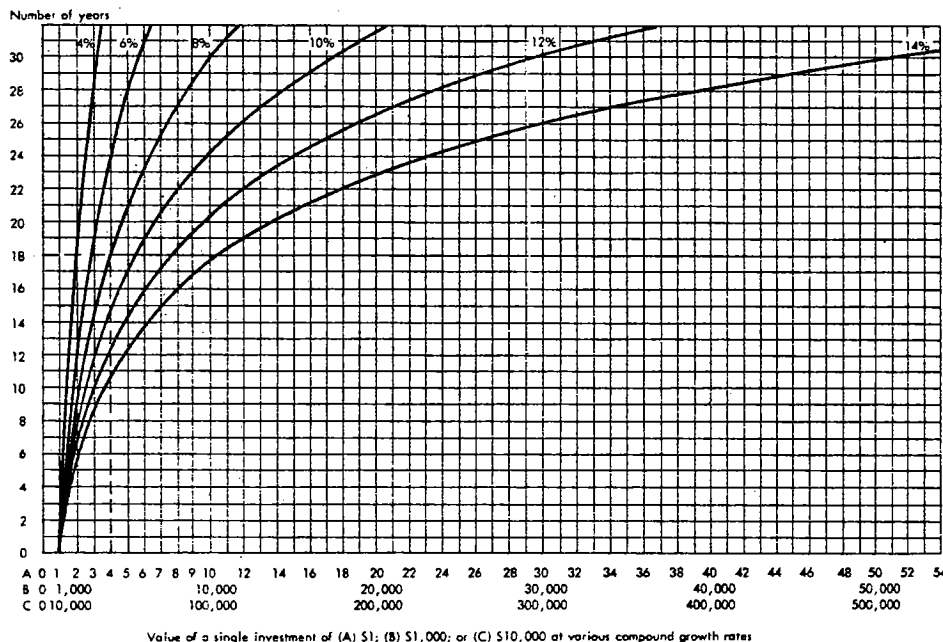
I am including a chart below that shows how tax deferred interest bearing items grow. For instance, follow the 12% line (and 12% or better is what you can now get on Treasury bonds). In ten years \$1,000 will grow to \$9,646. In 30 years that \$1,000 will grow to \$29,959. In my opinion, it's almost impossible to beat this kind of appreciation (given this kind of surety) with any other investment.

Question: That's all very interesting, Russell, but if \$1,000 is to grow to almost \$30,000 in thirty years, won't the Federal debt and inflation also have to go through the roof in order to support that kind of return?

Answer: Ah, there you have asked the ultimate question. And my answer is that here we are entering the realm of the unknown. In other words, it is possible that the \$1,000 you invest in Treasury bonds here in 1984 will be worth one-thirtieth or roughly \$33 in the year 2014, this in order (for the Government) to finance the debt at a 12% rate of return.

I have a few further comments in regard to this question. First, I feel it is getting to the point where the people are going to mandate a halt to monstrous Federal spending. Such action could come through the vote or through a Constitutional Convention which mandates a balanced budget.

Question: Russell, if the Government is forced to balance the budget, won't we see a collapse in this Country?



Answer: Yes, I think we will. We will see an unbelievably severe depression as the nation is forced to live on what it takes in rather than what it can take in and borrow. So the choice, as I see it, the ultimate choice, is in how the American people lose their buying power. We will lose it (1) through inflation, or (2) through a depression. But we will ultimately lose it just as surely as that chart of compounding interest is mathematically correct.

Question: OK, Russell, then why recommend high-yielding T-bonds? Why not recommend gold? Or how about T-bills?

Answer: All right, let me revise my original suggestion. We are trying to hang on to our buying power plus receive interest (tax deferred) on our capital. Then my best suggestion would be to place 1/3 of your funds in longer term bonds, one-third in T-bills, and a final third in gold-related items. Actually, my personal predilection would be to buy less gold or gold shares (maybe 15%) and take the remaining 85% and split it between T-bonds and T-bills (on the theory that leverage in gold shares is tremendous and any rush into gold would probably carry the gold items to great heights based on an emotional rush into this kind of inflation-protection item).

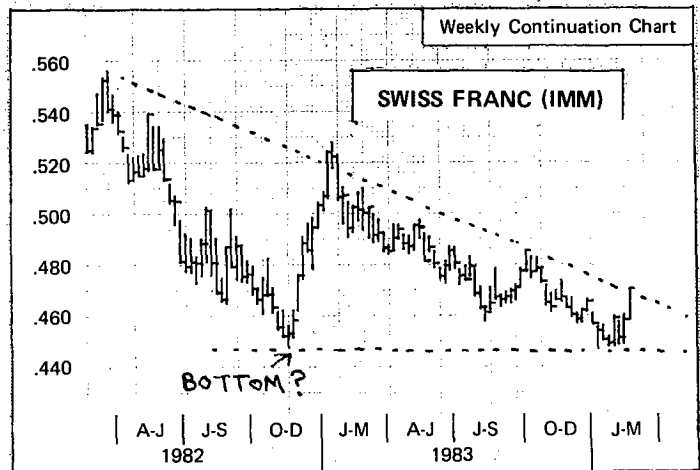
Question: Russell, your scenario of an ultimate collapse in buying power is very pessimistic, very defeatist. Doesn't that bother you?

Answer: Yes, it does. But I believe I am a realist. I try to deal with what is. The fact is that there is 5-7 trillion dollars worth of debt in this nation, and it's compounding. In the final analysis, this compounding monster will have to be inflated away or bankrupted away. Nothing grows to the sky, not even the total US debt.

GOLD; SILVER: All eyes are on the precious metals now. Why? Technically, my gold/common stock has turned decisively in favor of gold. Gold momentum has also turned up. Then there are the fundamentals. If the dollar tops out a lot of foreign money is going to head for the exits. In 1975, for instance, foreign holdings of US Federal debt was \$66 billion. Foreign holdings of Fed. debt was now a record \$160 billion, and we pay \$18 billion a year just to service that ghastly amount. So IF the dollar has topped, it won't be a happy occasion, you can bet on that.

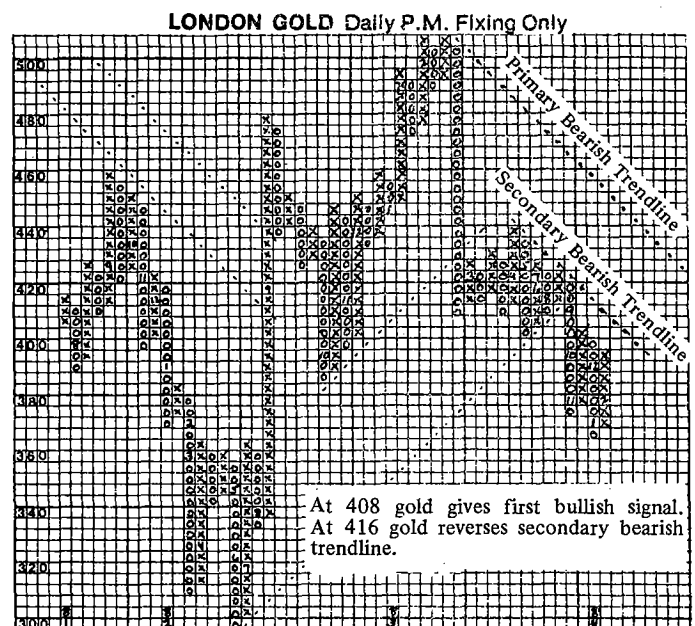
One item foreigners watch is our balance-of-payments. The US BOP is now drastically negative, and this year it could expand to \$100 billion or more. That would mean that we are buying our heads off from foreigners while foreigners aren't buying our goods. Keep that up for a few years, and the US would look more like a banana republic than it already does. A careening BOP deficit also provides the groundwork of a run on the dollar. A run on the dollar would present the Fed with a terrible choice. The Fed would have to push interest rates up so high that dollars would stay here—or ease up and try to keep US business rolling along. Neither choice is exactly an appetizing one, but then debtor nations (such as the US) are always faced with crises and difficult choices.

Has the dollar actually topped out? I'm not yet convinced. This (courtesy Dunn & Hargitt) chart shows the Swiss franc, and the franc is still battling against major *descending* trendlines. For a real turn to the upside, I'd like to see the franc better .49 (which would be impressive and suggest that the dollar had finally topped out or that the franc had definitely bottomed).



As for gold, I stated last week that gold momentum has finally reversed a 17-month declining trendline. This is bullish. The gold/stock ratio has turned up in favor of gold—also bullish. But I'm still not sold. I want to see more.

"Why so hesitant, Russell?" you ask, "Why not pile in on gold now?" And my answer is that it bothers me that so many hard-money people have been so quick to call the turn. Suddenly, everybody is bullish on gold, and the fact is that many hard money advisories never did become bearish on gold—throughout the long decline from the 1980 highs. Last week I received one report that announces "The Coming Panic for Gold." And all this may come true, but I want to see more convincing action from the gold price movement. I want to see the price movement say something and something is 420 for spot gold. At 420, I say, "Start buying gold, buy the coins, buy a no-load gold fund." By the way, ASA is now selling at net assets or at a slight premium. Gold has usually been a buy when ASA sold at a big discount. What we have here is the gold shares off into space, but the bullion has not really said "bull market" yet.



NEXT MAILING: March 21